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Chaebols, Financial Liberalization, and Economic Crisis: Transformation of Quasi-Internal Organization in Korea

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This paper argues that the course and outcome of the post-1993 financial reform in Korea were largely influenced by the interest politics of the most powerful interest group in Korea, *chaebols*, and thus an examination of their influence is essential to understanding the cause of Korea's financial crisis of 1997-98. The paper concludes that a financial reform undertaken in a haphazard manner, manipulated by a few dominant players in the economy runs into the danger of producing an outcome worse than before.

Key words: financial liberalization, Asian crisis, *Chaebols*, political economy.
JEL classifications: G28, L52, O53.

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1. Introduction

The Asian financial crisis of 1997-98, which revealed fundamental weaknesses in Asia's financial systems, has raised questions about the manner in which financial liberalization was carried out in the region in the years preceding the crisis. In the case of South Korea (henceforth Korea), the ascendancy of free-market ideology in economic policymaking in the early 1980s and the increasing external pressure on Korea to open financial markets set the stage for its financial liberalization (Choi 1993). It is, however, the interest politics of *chaebols* (Korea's large family-owned conglomerates) that influenced the manner in which the post-1993 financial liberalization was carried out and its outcome. We thus contend that the cause of Korea's financial crisis cannot be fully understood unless we first examine *chaebols*' influence on Korea's financial liberalization.

We interpret the whole course of the financial development and liberalization in Korea since the 1960s in the framework of the "quasi-internal organization"—a conceptual framework that regards the close, long-term relationship between the government and *chaebols* as that of a hierarchical internal organization (C. Lee 1992). This system was effective in promoting economic development until the mid-1980s when the supremacy of state over *chaebols* prevailed. But the success of the system in turn planted the seeds of its own destruction as *chaebols*—the system's creature—grew to dominate the national economy and became increasingly influential over the nation's economic policy-making. The post-1993 financial liberalization is a manifestation of this change in the power relationship between the state and *chaebols*.

In Korea, in spite of this change in the government-business relationship, there persisted the "too-big-to-fail" mentality—a legacy of the Park Chung Hee regime (Yoo, forthcoming). *Chaebols* continued to regard the government as their "risk partner" who would provide them with implicit insurance against failure, thus encouraging moral hazard on their part. Consequently, they expanded their businesses much faster and in a riskier manner than they would otherwise have done. Krueger and Yoo (2001), however, draw a much more sinister picture of Korean capitalism—"crony capitalism" that allowed politically well-connected *chaebols* to borrow and invest recklessly.

This paper is about the political economy of financial liberalization in Korea and *chaebols*' influence on the course and outcome of reform. The studies cited above clearly point to the reckless borrowing and investment by *chaebols* in the years following 1987. But what also needs to be said is that during the period of rapid economic growth Korea did not suffer from reckless borrowing and investment by *chaebols* and never suffered the ignominy of being called crony capitalism. Thus what remains to be told is how such a behavior by *chaebols* became to be possible and how they might have manipulated financial liberalization to their parochial benefit. What we hope to learn from the Korean experience in financial liberalization is not, therefore, about the ultimate goals of financial reform but how or how not to carry it out.

In the following section we set out a conceptual framework for analyzing the course of financial liberalization in Korea. In sections 3 and 4 we point out that between 1987 and 1992 the state lost its control over *chaebols,* and this loss allowed them to have a strong voice in shaping the course and outcome of financial liberalization in the 1990s. In section 5 we focus on the consequences of liberalization, especially on the merchant banks that were a major beneficiary of liberalization and whose reckless expansion was a causal factor of the crisis. In section 6 we provide an overall assessment of the mechanism underlying the course of financial development in Korea and conclude with some policy lessons.

2. Conceptual Framework: An Extension of the Quasi-Internal Organization Framework

State intervention in Korea has often been described by the term industrial policy, which aims at promoting specific industries by selecting a specific firm or firms for the task. The government and the private enterprises thus selected maintained a close, long-term cooperative relationship with the former participating in the decisions of the latter. C. Lee (1992) conceptualizes such close relations between the government and *chaebols* in Korea as resembling those in a hierarchical, internal organization (Williamson 1975) and thus argues that the government and *chaebols* in Korea should be viewed as constituting a "quasi-internal organization". State intervention with private firms is then equivalent to internal directives of the corporate head office to its subunits in a multi-divisional corporation. And, for the reasons that directives of corporate headquarters can be effective and efficient in achieving corporate objectives can state intervention be effective and efficient in achieving the developmental objectives of the state. In Korea, such state intervention has led to the rapid industrialization of an economy that was largely agrarian only forty-some years ago (Amsden 1989, Johnson 1982, Wade 1990).

The Korean experience suggests that policy implementation within the structure of the quasi-internal organization—"internal implementation"—can be more effective than parametric policy implementation through markets—"market implementation". This advantage in implementation is due to the economies in transactions costs that the quasi-internal organization can provide over market. That is, direct and continuous contact between the government and large private enterprises permits the sharing of information that would be done otherwise indirectly at a greater cost through prices in market implementation.

In Korea, the government possessed non-price as well as price incentives and control techniques to be brought to bear upon *chaebols* in a selective manner. It could coordinate interdependent enterprises to adapt to unforeseen contingencies, and it could resolve by fiat small-number bargaining indeterminacy among enterprises to the benefit of the public good. Thus with better information and with various incentives and control techniques the government could see to it that its policies were effectively carried out by *chaebols* (C. Lee 1992, Jones and Sakong 1980, Williamson 1975).[1]

One important condition for the quasi-internal organization to be effective in promoting economic development was that it checked the bureaucrat-business collusion in rent seeking. By mobilizing domestic savings from the entire nation but by allocating them mostly to *chaebols* through its control of the financial system the government created rents for the select few. The proportion of the rents going to the bureaucrats was, however, minimized because the competition for subsidized credit was based on the objective and transparent criterion of export performance. By adopting an outward-oriented development strategy and by exposing all the competitors for subsidized credit

[1] Internal implementation can be quick in achieving tangible, but not necessarily economically efficient, outcomes. Eads and Yamamura (1987, 447-448) also warned against the belief that the state's industrial policy has the unquestionable ability to create competitive advantage, by illustrating several cases of failure despite MITI's aggressive guidance and assistance. The point is that industrial policy cannot totally substitute for underlying economic conditions; rather, it acts within the framework of existing economic conditions.

to the discipline of world market prices, the government established a clear rule for allocating subsidized credit within the quasi-internal organization. Thus the bureaucrats had little discretion for allocating credit and, as a result, the rents from the subsidized credit was largely retained for reinvestment by the firms that were highly competitive in exporting their products.

In sum, the efficacy of the quasi-internal organization as a growth-promoting institution requires a hard state that can subordinate *chaebols* to its developmental goals and objective and transparent rules for allocating credit. One of the causes for Korea's economic crisis of 1997-98 is that by the late 1980s these necessary conditions no longer existed in Korea. In other words, there no longer existed a hard state, and with financial liberalization the linkage between exports and credits disappeared with no alternative purposeful mechanism for credit allocation, let alone a free standing banking system and functioning capital markets. This vacuum was filled by the bureaucrats who nevertheless continued interfering with credit allocation and capital markets but without any clear purposeful direction from the state. Worse, the bureaucrats were being captured by *chaebols* that were becoming increasing independent of the state, indirectly serving their own parochial interest and not that of the national economy. In other words, in Korea the shell of the quasi-internal organization continued to exist but without the prerequisite conditions that had made it an effective and efficient instrument for economic development in the earlier days.

This change in the quasi-internal organization took place when *chaebols* were becoming less dependent on the state for their financial requirements but the government was becoming no less dependent on them to keep the national economy going. Owing to financial liberalization and capital account opening in the 1980s and 1990s, *chaebols* gained alternative sources of finance and became less dependent on government-controlled commercial banks. Specifically, in the 1980s the government allowed various non-bank financial institutions to grow in a relatively free environment, and *chaebols* took advantage of those measures and became the owners of some of the new financial institutions. And, the reforms carried out in the 1990s made it possible for banks, including merchant banks, and *chaebols* to borrow abroad.

The subsequent sections basically recount this transformation in the government-business relationship in Korea, arguing how the government was held up by *chaebols* and how the specific manner in which financial reforms were carried out in the 1980s and 1990s basically reflected the interests of *chaebols*. The Korean financial crisis of 1997-98 is a result of this misbegotten financial liberalization.

3. Demise of the Quasi-Internal Organization and the State-Controlled Financial System

In the early 1980s the government began a round of financial liberalization as part of its overall structural adjustment program (Corbo and Suh 1992).[2] It sold off government-held shares in commercial banks while imposing an 8 percent limit on the number of shares of a bank that an individual person or *chaebols* could own. It also removed a number of entry restrictions, thus making possible the establishment of foreign joint-venture banks, regional banks and non-bank financial institutions (NBFIs) such as insurance and security companies. The commercial banks were also given the freedom to

[2] For Korea's earlier experiences in financial liberalization, see Nam and Lee (1995), Cho

set interest rates on regular deposits and loans and on corporate bonds, commercial papers, and transferable certificates of deposit. NBFIs were also given more freedom in setting interest rates.

As it turned out, the financial liberalization of the 1980s was more about interest rate deregulation and less about credit allocation. Although the share of policy loans in total domestic credit was reduced due to the growth of NBFIs, it was still about 60 percent of total commercial bank loans throughout the 1980s. Such a large share of policy loans is a clear indication that even though the government no longer owned the commercial banks it did influence their credit allocation through various administrative measures.

In sum, the financial reform of the 1980s was not a full-scale financial liberalization since the government still retained much of its influence over credit allocation (Dalla and Khatkhate 1995). The mixed outcome of the reform was partly due to the interest of the private sector led by *chaebols* that were concerned with adverse effects on their balance sheet that higher market-determined interest rates would have upon a full-scale financial liberalization. It was also due to opposition by the bureaucrats who feared the loss of their power that such financial liberalization would bring about.

One outcome of financial reform in the 1980s was the growth of NBFIs and stock and bond markets, which had the effect of bringing kerb market funds into formal financial institutions, mobilizing savings, and reducing corporate indebtedness. In fact, NBFIs' share in total deposits increased from less than 30 percent up to 1980 to more than 60 percent by the early 1990s and beginning in 1988 their share of deposits

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and Kim (1995), and Dalla and Khatkhate (1995).

surpassed that of banks (Table 1). The same can be said about their share of loans, which increased while the share of banks decreased and which exceeded that of banks by 1990. This rapid growth of NBFIs, which was due to their being subject to fewer regulations with respect to interest rates and policy loans than the commercial banks, was what the government intended to promote. What it did not, however, foresee was that NBFIs would displace the commercial banks as a major source of funds for *chaebols* (Leipziger and Petri 1993).

<Table 1: growth of commercial banks and NBFIs>

The Korean stock and bond markets also grew rapidly in the second half of the 1980s (Table 2). The ratio of the market capitalization of the listed companies to GNP (market value/GNP), which was less than 10 percent in the early 1980s, skyrocketed to 67.7 percent in 1989. Although it declined somewhat in the 1990s it has remained in the range of 30 to 40 percent since then. A similar pattern was also observed in the bond market, showing a big jump in growth in the late 1980s. Such a rapid growth of stock and bonds markets was in part due to a huge surplus in the balance of payments in the mid-1980s. But it was also due to government policies of promoting these markets as a way of lowering the corporate debt-equity ratio and opening *chaebols* to public ownership. Those policies included measures such as tax incentives, upgrading of stock market institutions, and increased monitoring and checking over irregular or illegal speculative investment (Amsden and Euh 1993, Cho and Kim 1995).

<Table 2: growth of capital markets>

Concomitant with the growth of NBFIs and stock and bond markets was a change in corporate financing, as these came to replace banks as a major source of funds.

The share of NBFI loans and direct financing increased from 38.1 percent in 1980 to 67.5 percent in 1988 and to 69.3 percent in 1990 while bank loans decreased from the peak of 35.4 percent in 1985 to 19.4 percent in 1989 and to 16.8 percent in 1990 (Table 3). Moreover, foreign bank loans to large firms decreased significantly in the 1980s when *chaebols* started raising funds directly in foreign bond markets.[3]

<Table 3: corporate financing>

One of the consequences of the change in corporate financing was the increasing autonomy of *chaebols* from the state, as they became less dependent on the government-controlled commercial banks. Their ownership of NBFIs further bolstered this autonomy. As of 1988, the top 30 *chaebols* owned 12 security companies (out of a total of 25), 18 insurance companies (out of a total of 35), and 18 investment trust companies (out of a total of 38). Although there was a ceiling on the number of shares that could be held by a *chaebol*, the top 30 *chaebols*, as a whole and directly and indirectly, owned about 30 percent of the total outstanding shares of the banking sector in 1988. These changes clearly indicate that by the late 1980s the government lost much of its power to influence *chaebols*' investment decisions. In other words, the late 1980s saw the demise of the quasi-internal organization that had been effectively used to promote economic growth in Korea during the preceding two decades. This is not to say that the Korean government did not try to control *chaebols*. In fact, several measures were introduced since the mid-

[3] It was Samsung that first floated bonds in a foreign bond market in 1985. Subsequent to that, many other *chaebols* floated bonds abroad. Their total accumulated sum for the 1986-94 period amounted to $4.9 billion.

1980s for that purpose but to no avail (Lee 1997, Nam 1996).[4]

In the mid-1980s the government, for instance, introduced a system that imposed an upper limit on the total amount of credit (including bank loans and loan guarantees) that a *chaebol* could obtain. However, since *chaebols* were becoming less dependent on bank financing, this measure was not much of a constraint on their ability to obtain funds.

The government also tried to impose strict restrictions on the ownership of land and its use in order to control real estate speculation. It also tried to require the use of the "real name" in all bank accounts so as to keep track of the true identities of depositors and their transactions. In spite of a popular support for these measures, the government failed to implement them in the face of opposition by *chaebols* that argued such measures would bring about a serious economic recession.[5]

In the early 1990s the Korean government tried to adopt three policy measures in order to rein in the power of *chaebols*. The first was to make *chaebols* sell the land that they owned but was not being used for active business (the so-called May 8 Decree of 1990). The second measure was to reduce the scope of *chaebols*' activities by designating for each *chaebol* a maximum of three companies to specialize in the areas in which it supposedly had the strongest comparative advantage and growth potential. The third measure was to reduce ownership concentration by requiring owner families to dispose of some of their shares. The penalty for not following the first measure was higher interest payments for bank debts and an eventual credit moratorium. To implement

[4] It needs to be pointed out that contributing to the autonomy of *chaebols* was the shift in the government's policy stance toward free-market ideology in the eighties.
[5] There were other groups such as small and medium-sized enterprises that opposed the real name system, but *chaebols* were the most organized group opposed to it and therefore most effective.

the other two measures the government offered incentives such as the lifting of upper limits on credit for the three companies selected by each *chaebol* for specialization and for whatever number of other companies in which the owner-family share was less than 10 percent of outstanding shares.

In spite of such penalties and incentives the government was not successful in inducing *chaebols* to adopt the measures. One month after the official deadline of March 1991 *chaebols* as a whole disposed of only 60.1 percent of the non-business related land.[6] Some *chaebols* were reported to have said that they would rather pay the interest penalty as they expected the land price appreciation to exceed the penalty. The incentives for specialization were also ineffective as *chaebols* could receive the same kind of credit benefit by designating any of their companies for a specialized line of product and then change the designation after three years. Thus, the net effect of the incentives was, as argued by some, only to free *chaebols* from credit control without changing either their ownership or the extent of their specialization.

All these events—attempts by the government to control *chaebols* and its failure to do so—is a testament to the fact that by the early 1990s the demise of the quasi-internal organization was complete and Korea needed a new system of economic management. There was, however, no serious debate on designing a system that could manage an economy increasingly dominated by powerful and ever-expanding *chaebols*. Instead, the prevailing paradigm in both academia and officialdom was a neoliberal,

[6] Report by the Bank Supervision Office of the Bank of Korea, which appeared in Han-Kuk-Il-Bo (April 25, 1991). Although since then, the government achieved some success in forcing *chaebols* to sell land, the delay revealed the weakened power of the state to enforce its policies relating to *chaebols*.

hands-off stance that regarded macroeconomic stability and deregulation sufficient for continued economic growth.

4. *Chaebols*' Influence on Financial liberalization

The 1990s saw an increasing demand from *chaebols* for deregulation such as lifting the ceiling on their ownership of bank shares, financial opening for greater freedom in foreign borrowing, raising the aggregate credit ceiling, and so on. *Chaebols* were successful in getting these measures adopted as they were consistent with the prevailing paradigm on economic management, as by then the government had no effective stick over *chaebols*, and as the bureaucracy had been increasingly co-opted by *chaebols*. In the event, in the 1990s *chaebols* launched a strong investment drive, exemplified in the rush into the petrochemical industry by several *chaebols* and the entry into automobile assembly by Samsung.

4.1. Domestic Liberalization: Entry and Interest Rate Deregulation

In the early 1990s, the government deregulated the entry and business scope of financial institutions in the belief that greater competition would result in increased economic efficiency in financial markets. One consequence of deregulation was a mushrooming of merchant banks. Many of the newly established merchant banks were formerly small-scale investment finance companies called *dan-ja-hoi-sa* that used to specialize in short-term commercial paper discounting and call-market loans. With the deregulation they simply changed their names and became merchant banks. In 1994, nine such merchant banks were established and, in 1996, additional sixteen were established. Many of these merchant banks were owned and controlled by *chaebols* since they had been the investment finance companies owned by the same *chaebols* and nothing else had changed but the name.

Another important deregulation in domestic financial business was a significant loosening of restriction on *chaebol* ownership of other NBFIs such as life insurance companies and investment trust companies. Before the deregulation, the top 15 *chaebols* were not allowed to own and control life insurance companies while the next top 15 *chaebols* were allowed to have only up to a 50 percent ownership of life insurance companies. But, in May 1996 all *chaebols* but the top 5 were allowed to own and control life insurance companies. Also, before the deregulation only the commercial banks could own investment trust companies, but in 1996 that restriction was abolished, resulting in *chaebols*' control of many of the investment trust companies.

Deregulation of entry restrictions did not result in the hoped-for improvement in efficiency in financial markets but instead in an increased control of NBFIs by *chaebols*. As a matter fact, as of 1995 the top 10 *chaebols* together owned 25 NBFIs with each owning on average 2.5 NBFIs (Table 4).

<Table 4: ownership of NBFIs>

In the 1990s, important progress was made in the deregulation of interest rates. This contrasts with the difficulty that the government had in the 1980s in deregulating interest rates (Choi 1993). Then, *chaebols* were opposed to interest-rate deregulation because they feared a heavier interest burden that higher market-determined interest rates would impose on them.   In the 1990s, in contrast, interest-rate deregulation went rather smoothly because *chaebols* saw an advantage in having free NBFIs and thus freer access to credit, albeit at higher interest rates than charged by the still regulated commercial banks. Thus, in 1993 the new government of President Kim Young Sam was able to declare the deregulation of all lending interest rates (except for policy loans) and many deposit interest rates, including long-term savings, corporate bonds, certificate of deposits, and checking account. The actual implementation of this deregulation policy took, however, a bizarre course.

As originally planned, long-term interest rates were to be deregulated before short-term interest rates. In the event, however, short-term interest rates such as the rates on the certificates of deposits and commercial papers of NBFIs were deregulated first in a speedy manner while time deposit rates of commercial banks were still under *de facto* government control. In loans, too, commercial bank lending rates and corporate bond interest rates remained subject to administrative guidance when all restrictions were removed from interest rates on NBFIs' commercial papers and from the amount that they could issue.

A consequence of this "short term commodities first, long term commodities later" deregulation was a rapid increase of the share of commercial papers in firms' external financing from 7.6 percent in 1992 to 16.1 percent in 1995 (Cho 1999). High-yield commercial papers and other short-term instruments became an important part of financial transactions with NBFIs being a major player in that business. As a result, the Korean financial market came to be dominated by short-term financial activities with a concomitant rise in overall financial risk. It also became a dualistic structure consisting of tightly controlled commercial banks still lending at low controlled interest rates and rapidly growing and relatively free NBFIs headed by merchant banks, lending at higher market-determined interest rates.

4.2. External Liberalization

Given that the top 30 *chaebols* were subject to an aggregate ceiling in the amount of bank credit they could obtain, they naturally turned to NBFIs for financing. They also sought financing from offshore banking and began demanding the liberalization of international financial transactions. This demand coincided with the pressure from international financial capital for access to the Korean market. The Korean government itself had good reason for accommodating this demand since it was keenly interested in joining the OECD, which required Korea's capital-account opening as a condition for its membership. This conjunction of forces made the post-1993 financial opening of Korea one of the most rapid and comprehensive ones in the developing world.

The measures taken to open the capital account included removing regulations on the issuance of foreign-currency denominated bonds by domestic firms and financial institutions, export-related foreign borrowing and general commercial borrowing, and abolishing the annual ceiling on foreign-currency loans by financial institutions. These measures did not, however, apply equally to both long-term and short-term transactions: short-term transactions were fully deregulated while long-term transactions were either partially deregulated or not at all.

Why did the government carry out such unbalanced financial opening? The idea of financial liberalization was not something to which the Korean government was then fully committed. It still regarded it necessary to use the commercial banks as a vehicle for achieving policy objectives such as promoting small and medium-sized enterprises and establishing strategic industries.[7] The pressure for financial liberalization was increasing, however, from both *chaebols* that saw the advantage of having easy access to the global capital market through their NBFIs and foreign financial interests that saw profitable opportunities in investing in the booming Korean economy. Under such unyielding pressures the government undertook financial liberalization, giving in where pressure was strong and holding back where it was not (Cho, forthcoming). Given that NBFIs' activities were mainly in short-term transactions whereas those of the commercial banks were in longer-term maturity, the unbalanced financial opening—full deregulation on short-term transactions but not on long-term transactions—was an inevitable outcome of the interest politics playing on financial liberalization.

While financial liberalization—both external and internal—gave more freedom to *chaebols* in their search for financing, the government's ability to control them was substantially reduced since 1993. Although control over *chaebols* was deemed necessary to curb their highly concentrated economic power, government policy toward them was basically grounded on the so-called "free market principle", which gave them more freedom than ever. For instance, in 1993 the credit-ceiling scheme—the last stick that the government had over *chaebols*—was modified, exempting from the ceiling the affiliated companies that were in *chaebols*' chosen areas of specialization. Furthermore, the number of *chaebols* to which the ceiling applied was reduced from the top 50 to the top

[7]The Ministry of Finance and Economy supervised long-term foreign capital transactions while the Bank of Korea had jurisdiction over short-term foreign capital inflows, and the latter was reportedly a greater predilection toward financial liberalization than the former.

30 in 1993 and was further reduced to the top 10 in 1996. Restrictions on the holdings of non-business related land and the debt structure were also abolished. The ceiling on the ownership of bank shares was also raised in 1994, allowing more shares to be purchased by *chaebols*, and in 1996 they were given more freedom with respect to the ownership of NBFIs. Along with these measures of deregulation the government made effort to introduce stricter rules regarding cross debt guarantees, cross shareholdings, insider trading, the role of the board of directors, and the rights of minority shareholders. These efforts, however, failed to materialize into laws.

One consequence of the haphazard financial deregulation and lack of control over *chaebols* was a rapid debt-financed growth of investment accompanied with low profitability of investment in the 1990s. In fact, compared with Japan and Taiwan, Korea had the highest growth rates of investment and asset and the lowest profitability (Table 5). Especially noteworthy is a sudden increase in investment in the mid-1990s, namely 56.2 percent in 1994 and 43.6 percent in 1995.

<Table 5: comparison of profitability in Korea, Taiwan and Japan>

Another important aspect of this expansion by *chaebols*, apart from their low profitability, is that it was done at the expense of profitability for banks and other financial institutions. In 1997, for instance, the debt-asset ratio for *chaebols* that did not have affiliate finance companies was 45.9 percent whereas that for *chaebols* that had affiliate finance companies was 56.6 percent. And the rate of return on the assets of *chaebol*-affiliate finance companies was 0.27 percent whereas the rate of return for independent finance companies was 1.0 percent (J. Kim 1999). In other words, the *chaebol*-affiliated finance companies helped finance *chaebols*' expansion in the 1990s at the expense of their own profitability. As a result, when a c*haebol* went into bankruptcy it triggered the failure of the affiliate finance companies and, given the web of credit linkage among financial institutions, it also led to the failure of unrelated financial institutions.

5. Consequences of Liberalization without Adequate Supervision

5.1. Growth of Merchant Banks

The banking supervisory system that existed in Korea in the mid-1990s was a collection of supervisory responsibilities dispersed among several competing authorities. Supervisory responsibility over foreign currency denominated businesses of commercial banks was divided between the Ministry of Finance and Economy (MFE, a super-ministry created by merging the Economic Planning Board and the Ministry of Finance) and the Bank of Korea. The former supervised long-term foreign capital transactions and outward foreign direct investment while the latter had jurisdiction over short-term foreign capital inflows and their impact on the money supply. Further, while the MFE was in charge of designing economic policies relating to foreign exchange, the Bank of Korea was responsible for implementing them.

The problem of inadequate supervision was greater for merchant banks than for commercial banks. The commercial banks were subject to regular and relatively solid prudential supervision by the bank supervisory authorities under the Bank of Korea. The MFE was formally responsible for merchant banks but had neither the necessary supervisory manpower nor the know-how of supervision. Consequently, only a few randomly selected merchant banks were examined each year. Even then, it is doubtful whether the examination was done properly since many of the retired bureaucrats from the MFE held positions in the merchant banks and were actively involved in lobbying on their behalf.

The merchant banks were naturally inclined toward short-term borrowing at higher interest rates since they had neither good international credentials nor experience in international business. Consequently, their portfolios tended to be skewed toward high yield risky assets and were prone to term- and currency- mismatches with high vulnerability to market and liquidity risks. Furthermore, the *chaebol*-affiliated merchant banks tended to concentrate their loans to *chaebol*-affiliated firms. These merchant banks could make such related lending because they were not subject to the same lending restrictions that the commercial banks were subject to. For instance, a merchant bank could lend as much as 150 percent of its equity capital to any single borrower, whether an individual or *chaebol*, whereas the limit for a commercial bank was 45 percent. Not surprisingly, as of March 1997 the top 30 *chaebols* accounted for as much as 51 percent of the merchant banks' total outstanding loans. In early 1997, when Kia, an automobile manufacturer, was declared bankrupt, the non-performing loans of about 30 merchant banks amounted to 4,000 billion Won, which exceeded their total equity of 3,900 billion Won. The size of non-performing loans increased to 10,000 billion Won later in the year when several conglomerates (Jinro, Daenong, Sammi, and Wooseoung) joined Kia in bankruptcy.[8]

A similar situation existed in the case of a number of the offshore funds established by Korean security or investment companies. Their number grew rapidly

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[8] Reported at various hearings at the National Assembly of the Republic of Korea.

after 1994, reaching 166 in 1997. The total value of the 98 offshore funds set up by 28 security companies was as large as US$2.6 billion, and in 1997 their loss was estimated to be about 11,000 billion Korean Won.[9]

5.2. Short-Term "Borrowing Spree"

Starting in the mid-1980s Koreans were allowed to borrow abroad without government guarantee. It was, however, the post-1993 financial liberalization that made it decisively easier for Korean firms and financial institutions to borrow abroad, leading to a big surge in borrowing especially by the deregulated merchant banks. In 1992 and 1993, total short-term foreign borrowing by financial institutions was $1.2 billion and $1.1 billion, respectively, but it then jumped to more than $7 billion in 1994, $11.8 billion in 1995 and $12.6 billion in 1996.

In 1994, out of the total short-term borrowing of $7 billion by financial institutions, $5.3 billion were by commercial banks and only $0.87 billion by merchant banks. But, in 1996, the amount borrowed by merchant banks increased to $3.19 billion (a 267 percent increase from 1994) while that by commercial banks increased to $7.19 billion (a 34 percent increase from 1994), although the latter still accounted for more than twice the amount borrowed by the former. Foreign borrowing by non-financial institutions, notably by *chaebols*, also increased—from minus $2.66 billion in 1993 to $4.65 billion in 1994, $8.05 billion in 1995, $10.42 billion in 1996, and $18.07 billion in 1997 (Table 6).

<Table 6: foreign borrowing>

[9] Reported at various hearings at the National Assembly of the Republic of Korea.

What prompted this surge in foreign borrowing, especially in short-term borrowing, was that there was neither a limit on the amount that a merchant bank could borrow abroad nor effective monitoring over potential borrowers. This can be seen in the rapid increase in the number of foreign branches or subsidiaries of Korean banks—from 175 in 1993 to 273 in 1997. Many of them were ignorant in advanced financial techniques and risk management and dealt mainly with foreign subsidiaries of *chaebols* and among themselves. Furthermore, they received little supervision from either the head offices in Korea or government authorities.

5.3. Capital Exit by Stopping Rollover: The Crisis

While short-term borrowing abroad by *chaebols* increased rapidly they were not earning enough revenues to service their debt. Various measures of profitability all show that the top *chaebols*—the top 30 as well as the top 10—earned less in 1996 than in the preceding two years (Table 7).

<Table 7: *chaebols'* profitability>

Beginning in January 1997 there occurred a series of *chaebol* bankruptcies, starting with the Hanbo Steel. The Hanbo case is most typical of a reckless expansion financed with bank loans obtained through political connections. Following Hanbo, eight of the top 30 *chaebols* went bankrupt in 1997. Many of these bankrupt groups had a debt-equity ratio exceeding 500 percent, and in some cases it exceeded 1000 percent!

Another important feature of *chaebol* bankruptcies is that because of the cross-guarantee of debts among the affiliated firms of a *chaebol* an affiliated firm's bankruptcy led to the bankruptcy of other affiliated firms. This chain of bankruptcies eventually brought down the entire group, destroying the myth that *chaebols* are “too-big-to-fail”. The bankruptcy of several *chaebols* thus caused international investors to re-evaluate the creditworthiness of Korean borrowers, especially after the unfolding of the July 1997 financial crisis that engulfed Thailand and Malaysia.

The financial crisis in Southeast Asia turned many of the loans and investments by Korean banks and firms in the region into non-performing loans, which in turn caused the plummeting of their institutional credit rating (IMF 1998). In response, the Korean government undertook several corrective measures in August 1997: some of them were, however, either too late or ineffective and others turned out to be outright wrong measures. Too late or ineffective was the government effort to guarantee foreign debts of the Korean banks and to provide them, especially the merchant banks, with more foreign exchange loans. Wrong was the government intervention in the foreign exchange market in an attempt to defend the Korean won against the dollar, which quickly led to the depletion of foreign reserves. In the end, even the Korean government lost credibility when the official disclosure of the country’s foreign exchange reserves became questionable.

The fall in the creditworthiness of Korean firms and banks and the loss of credibility in the government finally resulted in a massive capital outflow as international creditors stopped rolling over the Korean debt (Table 8). Until then the rollover had been more or less automatic, the rollover rate being more than 100 percent up to June 1997; but in July it dropped to 89 percent and then to 59 percent in November. For the merchant banks the fall in the rollover rate began earlier in February, well before for the commercial banks, when it fell to 79 percent. This is a clear sign that many of the

Korean financial institutions were losing their creditworthiness in international capital markets well before the financial crisis in Southeast Asia had any adverse effect on their balance sheets.

<Table 8: rollover rates>

On December 1, 1997, with less than $3 billion left in its foreign exchange reserves the Korean government was forced to go to the IMF for an emergency loan. On December 4, 1997 the IMF announced a bailout package of $57 billion, but that did not stop the panic in the currency market. It was not until December 24, 1997, when the United States and other industrialized countries formally joined the IMF in rescuing Korea from the crisis, that the panic stopped with some degree of stability returning in the currency market.

6. Recapitulation and the Lessons

When Korea started on the course of industrialization in the early 1960s the role of its financial system was largely that of financing the growth of *chaebols* at the behest of the government. It was the state that made the decision in allocating subsidized credit, and the commercial banks, which were nationalized, served in effect as a channel of government-directed credit allocation. This system encouraged *chaebols* to pursue a heavily indebted growth strategy, and as long as the state was in control of credit allocation and *chaebols* had no major alternative source of credit the state was able to use them as an effective instrument for economic development. In time, however, *chaebols* grew and their power vis-à-vis the state increased as their place in the economy expanded. In consequence, the government could no longer unilaterally change its financial policy, freeing interest rates, as the resulting higher rates would have put a heavy debt burden on *chaebols*.

The 1965 financial liberalization in Korea, contrary to its theoretical prediction, actually served the temporary policy goal of inducing kerb-market funds into nationalized financial institutions. Even the real interest rates, which turned positive in 1965, returned to the negative zone in the early 1970s. The so-called August 3rd measure of 1972, especially, gave windfall gains to private business firms including *chaebols* by freezing all debt payments owed to kerb-market lenders. Throughout the 1980s the government undertook several measures of financial liberalization, but they did not change its basic stance of low interest rate policy.

In the early eighties the government began undertaking several measures of financial liberalization under the influence of rising free-market ideology and pressures from abroad to open financial markets. One of the byproducts of this financial liberalization was the growth of NBFIs, many of which were owned by *chaebols* and were used by them as a source of external financing. This access to an alternative source of finance gave *chaebols* greater independence from the government, and this independence plus their importance in the national economy gave them the political power to influence the manner in which the post-1993 financial liberalization was carried out.

In the early phase of Korea's economic development, when the government was in the position to select *chaebols* for subsidized credit, the quasi-internal organization was efficient as it could economize on the cost of information gathering and policy implementation. The success of the quasi-internal organization, however, planted the seeds of its own demise as *chaebols* grew and became a dominant force in the national economy. Once this stage had been reached the state lost control over *chaebols*, and they in turn began to have powerful influence on the policy-making of the state. Granted that free-market ideology and the increasing pressure from the outside world set the stage for financial liberalization in Korea, it was the interest politics of *chaebols* that shaped the final outcome of Korea's post-1993 financial liberalization.

Financial liberalization, if correctly carried out, is supposed to establish a competitive market in which many sellers of financial instruments compete in an open, rule-based manner. But, in an economy where there are a few dominant players with a strong stake in controlling their sources of finance, the course that financial liberalization takes may not be what many of its advocates had in mind. It will be manipulated to reflect the interests of big players, and its outcome is likely to be different from a competitive market.

Our analysis of the Korean experience clearly demonstrates that simply removing the state from financial markets in an economy dominated by a few large players will not necessarily lead to the establishment of a well-functioning financial system. In such an economy, as in Korea with its *chaebols*–a legacy of the earlier development strategy, a few dominant players will manipulate financial liberalization to achieve their parochial objectives that are not necessarily in the nation's interest. Thus, unless this structural problem of a few players dominating the economy is first resolved, deregulation—simply removing state intervention from markets—will not necessarily bring about an outcome beneficial to the nation. Worse, it may plant the seeds for a financial crisis on a later date.

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